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**BEFORE THE  
POSTAL RATE COMMISSION  
WASHINGTON DC 20268-0001**

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POSTAL RATE AND FEE CHANGES, 2000  
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) Docket No. R2000-1  
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**SUPPLEMENTAL TESTIMONY  
OF  
WALTER BERNHEIMER, II  
ON BEHALF OF  
DIRECT MARKETING ASSOCIATION, INC.**  
\_\_\_\_\_

**Communications Concerning This  
Testimony Should Be Addressed To:**

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1201 Pennsylvania Avenue, N.W  
Washington, D.C. 20004-2401  
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1     **AUTOBIOGRAPHICAL SKETCH**

2             My name is Walter Bernheimer, II, and I am President of Bernheimer  
3 Associates, a management consulting group located in Wellesley,  
4 Massachusetts, serving clients in the Direct Marketing industry. Prior to  
5 becoming a consultant, I served for 29 years in a variety of capacities, including  
6 the last 19 as President, of a holding company on the service side of the  
7 industry, comprised of a Direct Marketing Agency, a Commercial Printer, a  
8 Lettershop (including extensive Data Processing and Personalization  
9 operations), and a Fulfillment business. We sold the company in 1989/90. I  
10 received an undergraduate degree from Williams College (where I was Phi Beta  
11 Kappa), and an MS degree from Massachusetts Institute of Technology.

12            I have had a long term interest in Postal matters, and have been active in  
13 various Trade organizations. From 1984 to 1990, I served on the Board of  
14 Directors of The Direct Marketing Association, and since 1990 I have served on  
15 the DMA's Government Affairs Committee and Postal Subcommittee. From  
16 1980 to 1990, I served on the Board of Directors of the Mail Advertising Service  
17 Association, including a term as President. I am also a member of the  
18 Association for Postal Commerce and the Mailers Council.

19  
20     **I.       PURPOSE AND SCOPE OF TESTIMONY**  
21

22            The purpose of my testimony is to respond to the U.S. Postal Service's  
23 projection of its Revenue Requirement for the Test Year (2001) based on  
24 FY1999 results, as presented by USPS witness Patelunas, and, more  
25 specifically, to demonstrate that this projection is significantly overstated. This  
26 projection, as always, consists of three parts:

- 27            • An estimate of Test Year costs "rolled forward" from actual "Base Year"  
28            figures  
29            • A contingency  
30            • An amount for "prior year loss recovery"

31            I am not here to delve into the details of the expense estimates in any of  
32 the many cost segments for which the USPS has presented data. That is for

1 other "experts" to accomplish. Nor am I going to comment on the amount  
2 included for prior year loss recovery. Rather, I am focusing my primary attention  
3 on the contingency included in the 2001 Revenue Requirement, a contingency  
4 that is unjustifiable, unnecessary, and uncalled for.

## 5 6 **II. THE USPS REVENUE REQUIREMENT IS OVERSTATED**

7  
8 In building its projection of the Test Year Revenue Requirement, the  
9 USPS utilizes what could be termed a bottoms up approach - using detailed  
10 models of various cost segments, factoring up rolled forward costs from a prior,  
11 base year. The contingency request and prior year loss recovery, are added to  
12 yield the Revenue Requirement.

13 I utilize a completely different methodology in estimating revenue needs -  
14 more of a top down system, one that is based on historical, actual expense  
15 growth. This is a particularly easy method to apply in this Rate Case, because  
16 detailed data for the first eleven accounting periods of FY2000 has already been  
17 published. In addition, the USPS has chosen FY2001 to be its Test Year. In  
18 other words, we have sufficient information to make a very accurate estimate for  
19 the fiscal year immediately prior to the new Test Year - just a few weeks before  
20 that Test Year is to commence. Clearly, an estimate for FY2001 that is based on  
21 FY2000 data will be more reliable than one based on FY1999 data. And since  
22 we are close to the start of the Test Year, that FY2000 data, so current and so  
23 readily at hand, cannot be ignored when it comes to deciding what the Revenue  
24 Requirement for the Test Year should be.

25 The first step in my top down process is to estimate what Total Expense  
26 for FY2000 is going to be. Incidentally, all the data that will be cited below is  
27 taken directly from the Postal Service's own Financial and Operating Statements,  
28 as published at the end of each Accounting Period (APs 1 - 12) and Fiscal Year  
29 (AP13). As of the end of AP11 in FY2000, the USPS reported a Total Expense  
30 figure of \$54,291.2 billion, representing a 3.8% increase over the previous year's  
31 figure, \$52,297.6 billion. To arrive at a projection for the full year, we must make

an estimate for just two accounting periods, APs 12 and 13. In FY1999, Total Expense for the last 2 Accounting Periods was \$9,782.1 billion (AP13 Total Expense, less YTD AP11 Total Expense). By how much should this number be inflated to reach a reasonable estimate for the comparable period this year? In AP11 of FY2000 expense inflation was 3.0%, which was a 1/3 drop from AP10's expense growth rate of 4.5%. As noted, the AP11 YTD number is 3.8%. To be conservative, and for the purposes of this analysis, I have chosen to use the 4.5% figure. But it should be noted that the USPS has been on a cost cutting program, and AP11's 3.0% number may prove to be more accurate. In any case, increasing FY1999's expenses in the final two accounting periods by 4.5% yields an estimate of \$10,222.3 billion for the same two periods this year, which would bring FY2000's Total Expense to \$64,513.5 billion, a 3.9% increase over FY1999.

In the current case, the USPS recently restated its Revenue Requirement for the 2001 Test Year as \$69,644.9 billion, comprised of three elements:

Total Accrued Costs	67,642.1
Contingency	1,691.1
Recovery of Prior Year Losses	311.7

The sum, \$69,644.9 billion, represents an 8.0% rate of growth over my previously stated estimate for FY2000 of \$64,513.5 billion. It should be obvious to even the most biased observer that such a rate of growth is exaggerated and unreasonable.

What could possibly explain such a jump? A sudden increase in the broad rate of inflation, perhaps to double digit levels? Not expected. Nor does inflation behave like that; the transitions are generally more gradual. In addition, the general rate of inflation affects only 20% or so of the USPS's costs. Fuel costs? Transportation costs are up by 12.6% in FY2000 according to the AP11 report, or \$450 million in total, but fuel is only part of it. In fact, most observers expect fuel costs to fall next year. What about a large surge in employment

1 costs, which represents the lion's share of Total Expense? Not possible. These  
2 numbers are contractual and largely known as of today - even with a contract  
3 about to be negotiated. And it is this year's rate of inflation that will impact next  
4 year's COLA, not next year's rate of inflation. How about a big drop in  
5 productivity? While it is true that productivity at the USPS has lagged that of the  
6 outside world, the trend this year has been toward productivity improvement, not  
7 decline. With investment in automation continuing, why would productivity  
8 decline next year? What about a big increase in unit volume, one that would  
9 force the USPS to expand employment? Unit volume is up by 2.7% for the first  
10 11 APs of FY2000, and it was up 2.5% last year. Not a big jump, and no sign of  
11 such a future jump is in evidence. And employment is down in FY2000, even in  
12 the face of higher unit volume. Why, then, would employment not continue to  
13 decline in the face of even slower unit growth?

14 In fact, the USPS is predicting significant deceleration in the rate of growth  
15 in unit volume, not acceleration. It has projected 207.6 billion units for FY2001.  
16 How will this compare to the current year? Through AP11 of FY2000, the USPS  
17 reported processing 175.2 billion units. In the last two Accounting Periods of  
18 FY1999, it processed 29.9 billion units. If the rate of volume growth for the last  
19 two APs this year slows to the level of AP11 (1.7%), one of the lowest increases  
20 of the year, APs 12 and 13 will come to 30.5 billion units, bringing the full year up  
21 to 205.6 billion units (2.5% above FY1999). Thus, the USPS Rate Case  
22 projection of 207.6 billion units for the Test Year would represent growth over  
23 FY2000 of just 1.2%. Interestingly, in the Rate Case, according to the Exhibit  
24 USPS-14G, "Cost and Revenue Analysis FY2000 with Workyear Mix Adjustment  
25 Statistics by Class of Mail", the units projected for FY2000 add up to 207.1 billion  
26 (1.5 billion more than what the USPS will actually be processing). Thus, the  
27 projected rate of increase in units for the Test Year embedded in the Rate Case  
28 is only 0.3%, far too low a number in and of itself. (I am not going to go into the  
29 details of the volume projections, but a possible source for the prediction of  
30 overall slow growth appears to relate to Standard A, where the USPS may be  
31 estimating that volume will decline.

Why this would happen is not clear.) To arrive at a better estimate of Test Year volumes, more realistic percentages must be applied to FY2000's actual volume results. Otherwise, projected Test Year revenue will be significantly understated. See Exhibit A for the calculation of FY2000 AP 12 and 13 and Full Year numbers, and Exhibit C for a listing of projected volumes by category.

How does the USPS's assertion of higher expense growth combined with lower unit growth compare to its results in the recent past? The following table shows the performance of the Postal Service regarding expense and volume growth since FY1993. As previously mentioned, all figures through FY1999 have been based on data in the Financial and Operating Statements for AP13 of each year. When volume figures have been revised, as they have been on several occasions, I have used the revised figures. Also, FY2000 has been estimated as described above. All of the numbers on which the percentages are based are shown in Exhibit A.

	<u>Expense Growth</u>	<u>Volume Growth</u>
1993 to 1994	4.5%	3.5%
1994 to 1995	4.8%	2.3%
1995 to 1996	3.9%	1.3%
1996 to 1997	3.9%	4.1%
1997 to 1998	4.3%	3.0%
1998 to 1999	4.7%	2.5%
1999 to 2000 est	3.9%	2.5%

The seven year averages are 4.3% annual growth in expenses, and 2.6% growth in unit volume. So where does 8.0% expense growth, coupled with only 1.2% volume growth, come from?

Another way to look at these numbers is to subtract the Volume Growth figure from the Expense Growth figure. The bigger the difference, the more anomalous the USPS's performance. The resulting "Report Card":

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Expense Growth Minus Volume Growth

1993	0.6 points
1994	1.0 points
1995	1.5 points
1996	2.6 points
1997	-0.2 points
1998	1.3 points
1999	2.2 points
2000	1.4 points

The average difference is about 1.3 points. The projected difference for Test Year 2001 is 6.8 points! If this were actually to materialize, management would certainly be due a failing grade.

I believe that the USPS's suggested Test Year Expense scenario does not make sense - and that, very simply, it is not going to happen. The fact of the matter is, the USPS does not need \$69,644.9 billion in revenue to cover an equivalent level of expense in Test Year 2001, because that level of expense is not going to occur.

If by the remotest stretch of the imagination it were to develop, it would only be because of the grossest possible mismanagement by the USPS management team and Board of Governors. And by handing down a rate decision that awarded the amount of revenue the USPS is requesting, the Postal Rate Commission would be complicit in the mismanagement. The PRC would be granting the USPS a license to manage badly - a license not to control costs. It would be a license to accept continued underperformance when it comes to productivity improvement. It would be a license for USPS management to continue to pat itself on the back for beating an easy benchmark. It would be a license for the USPS to remain uncompetitive in areas where competition will be necessary for survival.

1           What am I suggesting? Something very easy to implement. Based on my  
2 quasi-macroeconomic methodology, at the very least, reduce the USPS's  
3 requested Revenue Requirement by the full amount of the Contingency included  
4 in the Rate Case. Remember, as I write this testimony, we are only 6 weeks  
5 before the beginning of the Test Year, and we have financial information through  
6 the first 11 Accounting Periods of the current year, information that it would be  
7 less than responsible to ignore. Stated another way, it is not reasonable to allow  
8 a contingency request based on rolled forward estimates tied to FY1999 data,  
9 without taking into account intervening data, the FY2000 financial and operating  
10 results. Those results are not for a few accounting periods, they are for almost  
11 the full year.

12           By the way, what is the practical effect of entirely eliminating the  
13 Contingency. It will reduce the Revenue Requirement by \$1,691.1 billion,  
14 bringing it down to \$67,953.8 billion - still about 5.3% higher than my projection  
15 of FY2000's Total Expense number. Again, a reality check: 5.3% would be the  
16 highest rate of increase in expenses in the past 8 years. And, based on the  
17 USPS's volume projection for FY2001, this would be occurring against the  
18 background of a 1.2% increase in units, the lowest rate of increase in that same  
19 period. Let me repeat. Completely eliminating the Contingency request would  
20 allow the USPS the highest annual rate of increase in costs since the early  
21 1990s, even though volume growth will be lower than in all of the same years. It  
22 would also allow the Postal Rate Commission to eliminate the Prior Year Loss  
23 Recovery, and leave room to cut the Revenue Requirement by \$300 million more  
24 based on testimony related to specific cost segments. Or the PRC could leave  
25 the Loss Recovery intact, and cut \$600 million based on the cost segment  
26 testimony. Either way, these actions would reduce the USPS's requested  
27 Revenue Requirement to \$67.3 billion, a sum that represents a 4.3% increase in  
28 costs over FY2000, the average of the past 8 years.

29           An interesting exercise to go through, given that whatever rates are to be  
30 granted will not actually go into effect at the outset of the fiscal year, is to project  
31 financial results for the USPS for Fiscal Years 2001 and 2002. The latter year is



1 relevant because, based on past experience, the rates that will go into effect as  
2 a result of this rate case will almost surely last through that period. The  
3 assumptions underlying the P & L projections for FY2001 and FY2002 are:

- 4 • New rates go into effect during FY2001 that will affect 2/3 of the unit  
5 volume for the year.
- 6 • The rates will be based on a Revenue Requirement that excludes the  
7 complete Contingency request. In addition, it is assumed that other  
8 cuts will be made, so that rates will be increased by an average of  
9 4.6%. The resulting average revenue per unit after the rate increase  
10 will be 31.46 cents (as opposed to the 30.08 cents I am projecting for  
11 FY2000).
- 12 • Unit volume in FY2000 will be 205.6 billion units.
- 13 • Unit volume will increase 2% in both FY2001 and FY2002, a rate that  
14 is less than that of the recent past.
- 15 • Income not tied directly to rates, which has amounted to over \$2 billion  
16 through AP11 of FY2000, will reach about \$2.5 billion for the year.  
17 This figure will rise by about \$100 million in each of FY2001 and  
18 FY2002.
- 19 • Postal Service expenses will increase 4.3% in both FY2001 and  
20 FY2002, which matches the average of the recent past.

21 For a reality check, again note that this combination of 4.3% expense  
22 growth and 2.0% volume growth adds up to a difference of 2.3 points. The only  
23 year in the last 8 when 2.3 points will have been exceeded is 1996, when the  
24 difference was 2.6 points. The detailed P & L numbers resulting from the above  
25 assumptions are summarized in Exhibit B. They indicate that the USPS will  
26 generate a small loss in FY2000, about \$166 million. This compares to the  
27 USPS's own current expectations for a more than \$300 million loss. In FY2001,  
28 my numbers indicate that the USPS would show a profit of about \$331 million  
29 (based on partial year higher rates - not theoretical full year rates). And in  
30 FY2002, the USPS would realize a loss of \$309 million. In other words, over the

1 full two year period, the USPS, even with the lower rate increase, would show a  
2 cumulative profit.

3 But even this positive result masks what the USPS would earn in its  
4 theoretical Test Year. If the Revenue Requirement is based on the average rate  
5 of inflation in expenses for the past 8 years, 4.3%, then Total Expense will come  
6 to \$67,287.58 billion (i.e., 1.043 x my projected number for FY2000 Total  
7 Expense of \$64,513.5 billion). Deducting \$2.6 billion in "Other Revenue" from  
8 this sum yields a total of \$64,687.58 billion that has to be covered by revenue  
9 brought in from regular unit volume in order to achieve break-even. Applying a  
10 2% growth factor to FY2000's projected unit volume of 205.6 billion yields an  
11 estimate for the Test Year of 209.718 billion units. Thus, the revenue per unit  
12 required for break-even for the theoretical Test Year can be calculated as  
13 follows:

$$14 \quad 64,687.58/209.718 = 30.85 \text{ cents}$$

15 This number, 30.85 cents, is just 2.6% higher than the average rate that will be  
16 generated in FY2000. In other words, if the growth in expenses occurs at the  
17 average of the previous 8 years (and remember, the USPS has had lower cost  
18 growth in half of those years, and it has exceeded 4.3% in only one of the past 5  
19 years), all that is needed to break even in the theoretical Test Year is 2.6%  
20 higher rates.

21 Given all this information, given a very plausible financial model for the  
22 next two years, how can my suggestion about eliminating the Contingency  
23 request be deemed unreasonable? Stated another way, how can the USPS's  
24 own Contingency request, how can its own scenario, after all, only a model too,  
25 be considered sane and supportable? They cannot - and at the very least, the  
26 Contingency request should be eliminated - among other reductions. The  
27 Revenue Requirement should be cut sharply, and rates should be raised far less  
28 than the USPS has requested.

**Exhibit A**

**USPS Data (1)**

	<u>Expenses</u>	<u>% Change</u>	<u>Units</u>	<u>% Change</u>
1993	48,096.9	3.7%	170,222.7	3.1%
1994	50,273.9	4.5%	176,188.7	3.5%
1995	52,703.4	4.8%	180,233.2	2.3%
1996	54,739.8	3.9%	182,602.2	1.3%
1997	56,848.9	3.9%	190,009.9	4.1%
1998	59,294.2	4.3%	195,738.2	3.0%
1999	62,079.7	4.7%	200,543.9	2.5%
YTD AP11 1999	52,297.6		170,602.0	
YTD AP11 2000	54,291.2	3.8%	175,154.7	2.7%

**Computations Based on USPS Data**

AP12/13 1999 (1)	9,782.1		29,941.9	
AP12/13 2000	10,222.3	4.5%	30,450.9	1.7%
2000 Projn	64,513.5	3.9%	205,605.6	2.5%

(1) Source: USPS Financial and Operating Statements

**Exhibit B**

**USPS Profit & Loss Projections - FY2000 - FY2002**

	<u><b>FY2000</b></u>	<u><b>FY2001</b></u>	<u><b>FY2002</b></u>
<b>Operating Revenue</b>	<b>61,847.28</b>	<b>65,018.60</b>	<b>67,171.81</b>
<b>Other Revenue</b>	<b>2,500.00</b>	<b>2,600.00</b>	<b>2,700.00</b>
<b>Total Revenue</b>	<b>64,347.28</b>	<b>67,618.60</b>	<b>69,871.81</b>
 <b>Total Expense</b>	 <b>64,513.50</b>	 <b>67,287.58</b>	 <b>70,180.95</b>
 <b>Net Profit (Loss)</b>	 <b>- 166.22</b>	 <b>331.02</b>	 <b>- 309.14</b>
 <b>Unit Volume</b>	 <b>205,606</b>	 <b>209,718</b>	 <b>213,912</b>
<b>Op Revenue per Unit</b>	<b>0.3008</b>		
 <b>Unit Volume before Increase</b>		 <b>69,836</b>	
<b>Unit Volume after Increase</b>		<b>139,882</b>	<b>213,490</b>
 <b>Op Rev per Unit before Incr</b>		 <b>0.3008</b>	
<b>Op Rev per Unit after Incr</b>		<b>0.3146</b>	<b>0.3146</b>

**Exhibit C**

**USPS Volumes - 2000 - 2001 (in Millions)**

	<u>Actual 2000 Thru AP11 (1)</u>	<u>% Change Over 1999 (1)</u>	<u>USPS 2000 Projn (2)</u>	<u>USPS 2001 Projn (3)</u>	<u>% Change Over 2000</u>
Letters & Parcels			53,685.0	52,877.7	
Presort L & P			45,096.1	46,979.7	
Private Cards			2,855.2	2,770.8	
Private Cds Presort			2,600.1	2,670.2	
Subtotal First CI	87,710.7	1.2%	104,236.4	105,298.4	1.0%
Priority	1,053.3	3.0%	1,217.6	1,226.2	0.7%
Express	59.8	2.8%	69.9	72.3	3.4%
Mailgrams			3.9	3.3	-15.4%
Periodicals - Total	8,657.5	-1.4%	10,397.2	10,321.2	-0.7%
Standard A - ECR			32,691.2	32,828.2	
Standard A - Reg			41,673.6	40,998.7	
Non Profit - ECR			2,957.3	2,851.9	
Non Profit - Reg			11,255.4	11,425.6	
Subtotal Std A	75,550.9	5.0%	88,577.6	88,104.4	-0.5%
Standard B	922.9	5.5%	1,092.4	1,133.1	3.7%
USPS			359.4	348.5	-3.0%
Free			55.0	56.7	3.1%
International	859.4	-3.6%	1,048.8	1,031.6	-1.6%
All Other	340.2	-8.9%			
Grand Total	175,154.7	2.7%	207,058.2	207,595.7	0.3%

(1) Source: USPS Financial and Operating Statements

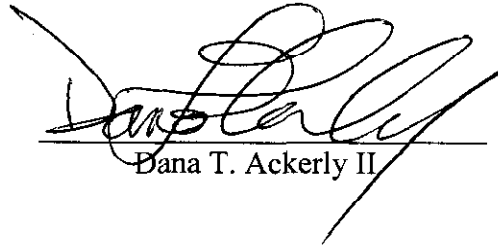
(2) Source: USPS-T-14, Exh. 14G

(3) Source: USPS-T-14, Exh. 14M

CERTIFICATE OF SERVICE

I hereby certify that I have this date served the foregoing documents in accordance with the Commission's Rules of Practice.

August 14, 2000



Dana T. Ackerly II